various restraints on the ability of incumbent LECs to offer new, innovative access services.[227] We note that Ameritech has proposed conditioning simplification of price cap regulation upon the achievement of certain competitive triggers.[228] We propose these changes because, once a LEC satisfies the triggers we have identified, competitive forces should come most quickly to bear on the provision of interstate access in low-cost geographic areas and to large customers. Removing these restraints should permit LECs greater ability to price economically and therefore bring more competitive pressures, including lower prices, in areas and for services where we expect competitive forces initially to be strongest. Such reforms would have the goal of fostering efficient and effective competition, to the benefit of customers, wherever possible. Without such reform, continuing uneconomic regulation may serve primarily to permit inefficient new entrants to gain market share among the most attractive customers rapidly. We seek comment generally on this analysis and specifically on the conditions and pricing reforms set out below. We also seek comment on whether we should modify any other of our regulatory pricing constraints at the time the Phase 1 competitive triggers have been met.

1. Trigger and Geographic Scope

169. We propose that the Phase 1 rule changes take effect when an incumbent LEC's network has been successfully opened to competition. The proposed Phase 1 rule changes remove restrictions that limit the ability of incumbent LECs to re-price access services in ways that respond to competitive pressure, but do not impede competitive entry. We seek comment on whether some or all of the tests described below provide the necessary and sufficient criteria for us to determine, for this purpose, whether an incumbent LEC's network has been opened to competition. We also seek comment on whether we should use any other test instead of, or in conjunction with, those we propose.

170. *Unbundled Network Elements.* The first condition we propose is that unbundled network elements be available at forward-looking economic cost, i.e., on the basis of the TELRIC of the network element (also known as Total Element Long Run Incremental Cost), plus a reasonable allocation of common cost. Unbundled elements provide a ubiquitous substitute for access service. Where access charges exceed forward-looking economic cost (due to the structure or level of access being inefficient), IXCs have an artificial incentive to

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[227] The Commission does permit some geographic deaveraging and some volume and term discounts, in limited circumstances in conjunction with expanded interconnection offerings. *See, e.g.*, Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369, 7454-56 (1992) (*Special Access Expanded Interconnection Order*) (geographic deaveraging); Transport Phase 1, Second Report and Order and Third Notice of Proposed Rulemaking, 8 FCC Rcd 7374, 7433-36 (1993) (*Switched Transport Expanded Interconnection Order*) (volume and term discounts).

[228] *Ameritech December 6 Letter* at 10-11.

"win" the customer and provide both local and toll service using unbundled elements. We expect that availability of unbundled elements at TELRIC prices as a substitute for access charges will ultimately require the LEC to set its charges in an economically efficient manner so as to give customers the most economic value consistent with covering costs. Will the availability of unbundled network elements at forward-looking economic costs drive LECs' access charges to efficient levels and structures? Or will it only tend to constrain the overall level of charges, and give incumbent LECs incentives to choose inefficiently high or inefficiently structured access charges, thus disadvantaging IXCs that are not effectively integrated into local service, and thus driving the market, possibly inefficiently, towards one-stop shopping? Commenters are asked to outline the specific mechanism by which such competition will affect access rates. Those who believe competition from unbundled network elements will not affect access rates should explain why.

171. In order for unbundled elements to promote ubiquitous competition effectively, prices for unbundled network elements must be geographically deaveraged. Costs may vary across geographic areas based on the density of the area served, topography, or other characteristics of the area. When the prices of elements that vary materially in cost are averaged, the ability to substitute unbundled elements for access will not drive access rates to their efficient level, because such prices will understate the cost of providing services over the elements in high-cost areas and overstate the cost of providing services over the elements in low-cost areas. When element prices have been deaveraged to reflect cost differences, any divergence between element prices and access charges required by regulation creates an artificial incentive to substitute unbundled elements for access.

172. We seek comment on whether, for purposes of implementing market-based access reform, an incumbent LEC should not be deemed to have satisfied the Phase 1 competitive triggers unless and until rates for unbundled network elements are available at geographically deaveraged, forward-looking economic costs in a manner that reflects the way costs are incurred. For the purpose of determining whether deaveraging has occurred, we tentatively conclude that there should must be at least three geographic zones.

173. *Transport and Termination.* The next condition we propose for Phase 1 is that transport and termination be available for local traffic at cost-based rates. Because unbundled network elements only act as an effective substitute for switched access where the requesting carrier can provide both local and interexchange service to the end user, a carrier must be able to offer ubiquitous local service at competitive rates. This requires transport and termination on the LEC network to be available at the incumbent LEC's additional cost. Even assuming rates are reciprocal, transport and termination rates that exceed cost impede efficient entry and limit the extent to which competitive LECs will compete for customers in local exchange and exchange access markets. Where a customer makes more calls than he receives, inflated transport and termination rates will impede competition for that customer. We seek comment on whether we should begin to implement market-based access reform for an incumbent LEC

before that incumbent LEC has complied with the statutory requirement to provide transport and termination at cost-based rates.

174. *Resale.* We also propose that, in order to gain Phase 1 treatment, an incumbent LEC must offer its retail services to resellers at a wholesale price, which is equal to the retail price minus the reasonably avoidable cost of providing wholesale rather than retail service. Congress provided that incumbent LECs should make their retail services available to new entrants at the retail rate less costs that will be avoided.[229] Although resellers do not compete with incumbent LECs in the provision of access, this requirement is a "stepping stone" in the provision of other forms of competition. Resale should provide new entrants with a vehicle for rapid entry into the local exchange retail marketplace and with the ability to compete throughout an incumbent LEC's service area. We seek comment on this proposal.

175. *Availability of Elements and Services.* Fourth, we propose that incumbent LECs be required to demonstrate that competitors are able actually to order and receive elements and services in a commercially reasonable manner and in necessary quantities. Provisioning limits and provisioning delays must not materially limit the flow of customers from the incumbent LEC to its rivals. Incumbent LECs must create well-functioning and adequately sized provisioning systems, both for resale and for unbundled elements. We invite parties to comment on this proposal.

176. *Other Factors.* We propose several other factors for determining whether a LEC has made its network available to competitors; namely, whether an incumbent LEC provides dialing parity and number portability, whether an incumbent LEC gives competitors access to its rights-of-way, and whether network standards are open and non-discriminatory. For example, without the provision of dialing parity, competitors' customers must dial additional digits. Without number portability, a customer's desire to keep his phone number becomes a barrier to new entrants. We seek comment on these factors, and invite parties to comment on the availability of any factor that should be taken into account in determining whether the Phase 1 trigger has been met.

177. We tentatively conclude that it is important to use objectively measurable criteria for determining whether an incumbent LEC has achieved the Phase 1 trigger, so as to avoid delay caused by protracted proceedings and to minimize administrative burdens for all parties. In determining whether an incumbent LEC meets the Phase 1 criteria, we tentatively conclude that the incumbent LEC seeking Phase 1 treatment offer us objective evidence of the existence of these conditions. After receiving the incumbent LEC's filing, we propose to allow for public comment. We propose that we would then issue our decision within 90 days after the comment period has ended. We seek comment on this proposed review mechanism.

[229] 47 U.S.C. §§ 251(c)(4) and 252(d)(3).

178. We solicit comment on the procedures that an incumbent LEC should follow to demonstrate that it has met the Phase 1 competitive trigger. Petitioners should discuss whether an incumbent LEC should file a petition for waiver, a petition for declaratory ruling, or some other filing, and how the incumbent LEC should satisfy its burden of proof. Because incumbent LECs are required to open their networks throughout each state in which they offer service, we propose to require that incumbent LECs meet this competitive trigger on a state-by-state basis in order to qualify for this relief. We ask, however, whether incumbent LECs should be able to seek Phase 1 treatment by geographic area, as discussed in Section IV.B., above, even though these areas would be smaller than study areas. We seek comment on this proposal.

179. We also invite parties to comment on what actions the Commission should take in the event that it is shown that a LEC that has received approval for Phase 1 or Phase 2 relief, or has demonstrated that substantial competition exists for a particular service, no longer satisfies the applicable criteria.[230] We particularly invite comment on whether the Commission's complaint process is the appropriate vehicle for parties to demonstrate the necessary changed circumstances and the specific remedies the Commission should employ in the event that an incumbent LEC no longer meets the applicable Phase 1 or Phase 2 criteria, or can no longer demonstrate the existence of substantial competition for a particular service.

2. Reforms

a. Geographic Deaveraging

180. Our Part 69 rules generally require that an incumbent LEC's charges for access elements be averaged within each of its study areas.[231] We have developed, however, a system of density pricing zones, which may be used by an incumbent LEC to deaverage geographically its rates for special access and switched transport services if that incumbent LEC meets certain threshold interconnection requirements.[232] We instituted this density zone

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[230] *See* Sections V.C, *infra*, and IV.B, *supra*.

[231] 47 C.F.R. § 69.3(e)(7). A study area is a geographical segment of a carrier's telephone operations. Generally, a study area corresponds to a carrier's entire service territory within a state. Thus, carriers operating in more than one state typically have one study area for each state, and carriers operating in a single state typically have a single study area. Carriers perform jurisdictional separations at the study area level. For jurisdictional separations purposes, the Commission adopted a rule freezing study area boundaries effective November 15, 1984. Part 36 of the Commission's Rules, 47 C.F.R., Part 36, Appendix-Glossary, definition of "Study Area." *See* MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket Nos. 78-72 and 80-286, 49 Fed. Reg. 48325 (Dec. 12, 1984), adopted by the Commission, 50 Fed. Reg. 939 (Jan. 8, 1985).

[232] 47 C.F.R. § 69.123. *See also Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7454-56.

pricing in response to the emergence of competition in markets for those services. In this Notice, we propose allowing incumbent LECs that have met the Phase 1 trigger to deaverage rates geographically for all access charge elements other than the SLC. We ask generally whether incumbent LECs should also be able to deaverage the SLC geographically. In the case of first residential lines and single-line business lines, should incumbent LECs be permitted only to make geographically-deaveraged reductions in the SLC, in light of the Joint Board's recommended decision that there be no increases in the SLC for those lines?[233]

181. Incumbent LECs addressing this issue in response to the *Price Cap Second FNPRM* generally supported immediate geographic deaveraging of their charges for access elements. They asserted that costs vary significantly between urban and rural areas. They argued that the Commission should allow incumbent LECs to begin to deaverage their rates across geographic regions because non-cost-based, averaged rates cannot be maintained when their markets are open to competition.[234] Other commenters, particularly IXCs, opposed geographic deaveraging of access charges, arguing that incumbent LECs had not presented evidence that zone pricing would result in the reduction of prices towards cost. In particular, AT&T opposed zone pricing for local switching, arguing that local switching was not subject to competition, and that it is unlikely that the costs of local switching vary with volume or geography in a manner similar to transport costs.[235] As a result, AT&T predicted that geographic deaveraging of the remaining access charge elements would lead to higher margins between price and cost and would perpetuate uneconomic cross-subsidies.

182. In this Notice, we propose to permit price cap incumbent LECs that satisfy the Phase 1 eligibility requirements to deaverage geographically their access charge elements. We note that the availability of geographically deaveraged unbundled network elements is proposed as a prerequisite for Phase 1 relief. Where unbundled network elements are deaveraged, continuing to require access rates to be averaged across the study area would foreclose the incumbent LEC from meeting competition from unbundled network elements in low-cost areas, while still requiring the incumbent LEC to charge below-cost access rates in high-cost areas. As discussed in Section III.B, above, we seek comment on whether section 254(e) requires geographic deaveraging. We also seek comment on the relationship between geographic deaveraging of access charges and section 254(g).[236]

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[233] In the *Universal Service Recommended Decision*, the Joint Board also recommended that there be a reduction in the SLC as applied to first residential lines and single-line business lines, if the Commission bases universal service contributions on all telecommunications revenues. *Universal Service Recommended Decision* at paras. 769-73.

[234] *E.g.*, Pacific Bell Comments at 27.

[235] AT&T Reply at 57-60.

[236] *See* Section II.B, *supra*.

183. Moreover, such discrepancies between price and cost distort competition by creating incentives for entry in low-cost areas by carriers whose cost of providing service is actually higher than the incumbent LEC's cost of serving that area. Similarly, geographic averaging across large geographic areas distorts the operation of markets in high-cost areas when we require incumbent LECs to continue offering services in those areas at prices substantially lower than their costs of providing those services. Prices that are below cost reduce the incentives for entry by firms that could provide the services as efficiently, or more efficiently, than the incumbent LEC. Therefore, we propose that once the requirements under Phase 1 have been met, incumbent LECs should be permitted to deaverage geographically rates for access elements.

184. We note that, pursuant to the *Special Access Expanded Interconnection Order* and the *Switched Transport Expanded Interconnection Order*, incumbent LECs currently may deaverage access charges for special access and switched transport services when one cross-connect has been taken within the study area.[237] Phase 1 deaveraging would be broader -- extending to all access elements other than the SLC, not just special access and switched transport -- and complementary to deaveraging under our *Expanded Interconnection* orders. Thus, for any incumbent price cap LECs that have not already met the one cross-connect threshold for transport deaveraging, we propose to permit geographic deaveraging for special access and switched transport when one cross-connect has been taken in the study area or when Phase 1 has been met, whichever is earlier.

185. We seek comment on the variability of the costs of providing access charge elements. In particular, we ask parties to submit evidence indicating whether per-line and/or per-minute costs of local switching services vary geographically. We also seek comment on the number and size of zones that should be required or allowed. One possible method is to permit or require that the geographic areas for access deaveraging match those implemented by each state pursuant to the 1996 Act. Because the prices for competitors using incumbent LEC unbundled network elements will differ among these density zones, it would seem necessary to permit incumbent LECs to price their own access services using the same areas. If the states deaverage network elements and the Commission does not deaverage access, IXCs would only purchase network elements in low-cost areas, and would only take access in high-cost areas. We seek comment on alternative approaches for ensuring that geographic zones generally reflect cost differences and that the zones for unbundled network elements, universal service, and access charges are compatible.[238] We also ask whether any other

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[237] *Special Transport Expanded Interconnection Order*, 7 FCC Rcd at 7454-55; *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7426 n.230. An interconnector will be deemed to have taken the cross-connect element when it has ordered the cross-connect and the LEC has provided this service.

[238] For example, different geographic zones may work for these purposes so long as the results are not widely disparate in any particular location.

geographic areas would be more appropriate than either of these options. Further, we seek comment on whether incumbent LECs should be permitted or required to change the density zones established for special access and switched transport to coincide with the zones we ultimately adopt in this proceeding. In considering how best to deaverage geographically the remaining access elements, we seek to minimize administrative burdens for incumbent LECs and the Commission.

186. Finally, we note that section 254(g) requires IXCs' rates to subscribers in rural and high cost areas to be no higher than the rates for subscribers in urban areas.[239] We therefore invite parties to comment on how IXCs would be affected by incumbent LECs geographically deaveraging their rates for access elements.

b. Volume and Term Discounts

187. In this section, we consider permitting incumbent LECs to offer volume and term discounts for all of their access charge elements upon achievement of the Phase 1 competitive conditions. Volume and term discounts are permitted for special access services without any competitive showing or waiver of Part 69 of the Commission's rules.[240] We currently permit volume and term discounts on certain transport services when incumbent LECs can show a certain level of competition, as evidenced by a specified demand for their expanded interconnection services. In the *Switched Transport Expanded Interconnection Order*, we permitted incumbent LECs, once a specified threshold of interconnection was met, to offer reasonable volume and term discounts on entrance facilities and interoffice facilities and tandem-switched transport, including pricing that reflects speeds greater than DS3. We noted that, as a general matter, such discounts should be permitted if they are justified by underlying costs, and are not otherwise unlawful, because they encourage efficiency and full competition.[241] Term discounts recognize cost savings that result from the certainty of longer-term arrangements, and volume discounts reflect the lower per-unit cost of providing higher traffic volumes on high capacity facilities.[242] We have previously concluded that volume and term discounts can reasonably recognize certain efficiencies that flow from volume or term commitments made by purchasers.[243]

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[239] 47 U.S.C. § 254(g).

[240] *See Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7458-65.

[241] *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7433-34.

[242] *See, e.g.*, Expanded Interconnection with Local Telephone Company Facilities, Memorandum Opinion and Order, CC Docket No. 91-141, 9 FCC Rcd 5154, 5202 (1994) (*Virtual Collocation Order*).

[243] *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7463.

188. The Commission currently allows an incumbent LEC to offer volume and term discounts on switched transport when one of the following conditions has been met: (1) 100 DS1-equivalent cross-connects for switched transport service were taken by an interconnector in the incumbent LEC's zone 1 offices in a study area, or (2) an average of 25 DS1-equivalent switched transport cross-connects per zone 1 office have been taken.[244] These thresholds were designed to balance the incumbent LECs' need for flexibility in light of growing competition with the need to give incumbent LECs incentive to act cooperatively in implementing expanded interconnection.[245] We found that discounted switched transport service constituted a new service under the price cap rules, thereby necessitating the filing of cost justification by the incumbent LEC.[246] We also required that discounted switched transport tariff filings be made 120 days in advance of their effective date, rather than 45 days in advance, as required for other new services.[247]

189. Incumbent LECs commenting on volume and term discounts in response to the *Price Cap Second FNPRM* generally supported the use of volume and term pricing on the ground that such pricing plans more accurately reflect the costs of providing access services to higher volume and longer term customers.[248] In particular, NYNEX stated that we should revise the Part 69 rules to permit volume and term discounts for usage-based switched access charges once barriers to entry into the market in local service had been removed, because "it will begin facing additional competition for these usage-based rates from CLECs who will offer their own Switched Access services."[249] AT&T, on the other hand, argued that volume and term discounts for switching are unjustified, and asserted that "the costs of switching generally do not vary with volume in the same way as the costs of transport, and therefore (unlike for transport), any economies of scale for switching are likely to be minimal or nonexistent."[250]

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[244] *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7434-35. In affirming our decision to permit volume and term discounts for transport, we specified that this threshold must be attained under the virtual collocation system adopted on July 14, 1994. *See Virtual Collocation Order*, 9 FCC Rcd at 5204.

[245] *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7434-35.

[246] *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7435.

[247] *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7435.

[248] NYNEX Comments at 25; Pacific Bell and Nevada Bell Comments at 25-28; Southwestern Bell Comments at 35.

[249] NYNEX Comments at 25-26.

[250] AT&T Comments at 29-30.

190. Because of our current inefficient rate structures, incumbent LECs face pressure from high-volume customers due to the availability of bypass facilities. The condition that incumbent LECs make available unbundled network elements at forward-looking economic costs, including substantial scale and scope economies, will place additional pressure on access prices that do not also reflect forward-looking economic costs. We recognize the significant benefits that may result from volume and term discounts, including the possibility that volume and term discounts may enable an incumbent LEC to reflect its actual costs more accurately. However, we do not propose permitting incumbent LECs to offer volume and term discounts without first meeting a competitive condition because we remain concerned that such discounts may serve to inhibit competition if employed by incumbent LECs before competitors can offer volume and term discounts of their own. By "locking in" customers with substantial discounts for long-term contracts and volume commitments before a new entrant that could become more efficient than the incumbent can offer comparable volume and term discounts, it is possible that even a relatively inefficient incumbent LEC may be able to forestall the day when the more efficient entrant is able to provide customers with better prices.

191. Because of this concern, we therefore propose that incumbent LECs be permitted to offer volume and term discounts only if they have met the Phase 1 conditions. The existence of competition from the availability of unbundled elements makes it less likely that an incumbent LEC could lock in particularly desirable customers with long-term plans before competitors can respond. Instead, it seems more likely that the competitors will be able to use unbundled network elements to offer services at significant, pro-competitive volume and term discounts. Precluding volume and term discounts for access service rates would require the incumbent LEC to offer local switching services purchased in high volume or for long terms at prices greater than the incumbent LEC's costs for providing those services, which would impede the full development of effective competition. We seek comment on this proposal to give incumbent LECs the authority to provide volume and term discounts, and on the extent to which it might affect the emergence of competition in markets for exchange access services. We seek comment on whether these discounts need to be cost justified.

192. On the other hand, we tentatively conclude that it would not be in the public interest to permit incumbent LECs to offer "growth discounts" for particular access services at Phase 1. Growth discounts refer to pricing plans under which incumbent LECs offer reduced per-unit access service prices for customers that commit to purchase a certain percentage above their past usage, or reduced prices based on growth in traffic placed over an incumbent LEC's network.[251] We are concerned that because BOC affiliates will begin with existing relationships with end users, name recognition, and no subscribers, they will grow much more

[251] For example, if a buyer purchased $100 of services for a given three-month period, the seller's offer of a five percent discount on the buyer's purchase for the next three-month period if the buyer committed to purchasing $120 of services during that time would be considered a growth discount.

quickly than existing IXCs and other new entrants. Thus, incumbent LECs could circumvent the nondiscrimination provisions of section 272 by offering growth discounts for which, as a practical matter, only their affiliates would qualify. Some incumbent LECs argued in comments filed in response to our *Price Cap Second FNPRM*, that growth discounts could benefit smaller IXCs that do not qualify for volume discounts. These incumbent LECs, however, failed to provide evidence that growth discounts would be cost-justified.[252] We invite parties to provide evidence that growth discounts would not circumvent the safeguards of section 272, and are, in fact, justified by reduced costs of providing service. We also seek comment on whether the development of competitive access markets would be enhanced if incumbent LECs were permitted to offer growth discounts.

c. Contract Tariffs and Individual RFP Responses

193. In the *Interexchange Order*, the Commission adopted rules permitting IXCs to offer common carrier services pursuant to individually negotiated contract tariffs. AT&T, then deemed as a dominant carrier, was permitted to offer services under contract tariff rates only for those services that we had found to be subject to substantial competition.[253] We required AT&T to file a tariff setting forth the terms of each negotiated contract, and to make the same terms and conditions generally available to similarly situated customers under substantially similar circumstances so as to comply with the nondiscrimination provisions of the Communications Act.[254]

194. In the *Price Cap Second FNPRM*, we proposed to apply similar contract carriage rules to access services that the Commission finds to be subject to substantial competition, provided the contract rates were made generally available to similarly situated customers under substantially similar circumstances. A range of industry commenters generally concurred with that proposal.[255] CompTel articulated a more cautious approach, however, submitting that contract carriage would be appropriate only after "all functionally similar services are subject to substantial competition," and should never be permitted between a LEC and an affiliated IXC.[256] Time Warner argued that, if contract carriage is permitted, public

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[252] Ameritech Update Reply Comments at 24-25.

[253] *Interexchange Order*, 6 FCC Rcd at 5897. In that context, streamlined regulation meant relieving AT&T of price cap requirements for specific services, and permitting AT&T to develop contract tariff rates for those services. *Id.*

[254] *Interexchange Order*, 6 FCC Rcd at 5897.

[255] *E.g.*, Ameritech Comments at 40-42; AT&T Reply at 49-51; BellSouth Comments at 57-58; GSA Comments at 18-19; MCI Comments at 34-35.

[256] CompTel Comments at 40; *see also* Sprint Reply at 3-4.

access to detailed information about those contracts (including access by competitors) is an important safeguard against abusive exercises of market power. Several incumbent LECs, on the other hand, contended that incumbent LECs should be permitted to offer contract carriage and, in particular, individualized responses to RFPs without having to satisfy competitive triggers. GTE, USTA, and U S West proposed that incumbent LECs be permitted to offer contract carriage in response to any RFP, provided that at least one other carrier first responds to the RFP.[257]

195. We propose to permit incumbent LECs to offer contract tariffs when Phase 1 has been met. Incumbent LECs would be required to make each contract tariff both publicly available through a tariff filing setting forth the contract's terms, and generally available to similarly-situated customers on the same terms and conditions. The availability of contract carriage should lead to lower prices for those customers using contract tariffs. Under our price cap rules, contract tariffs at reduced prices could allow incumbent LECs to raise prices for those customers not taking service subject to these contract tariffs due to the way the actual price indices (APIs) are calculated. At Phase 1, the entry barriers to competition will have been removed, but competition may not yet be sufficient to constrain the incumbent LECs from raising prices unreasonably for those customers not under contract tariffs. Thus, as suggested by Pacific Bell, we also propose to remove contract carriage service when calculating incumbent LECs' APIs in our price cap system.[258] We note that parties will be negotiating, or obtaining arbitration of individual arrangements before the states, under section 252, and that certain interconnection arrangements may be substitutable for access services. This may well place greater competitive pressure on prices for incumbent LEC access services at an earlier phase in the development of competition than existed for AT&T. Parties advocating that we should delay contract carriage until Phase 2 or until substantial competition has been reached should identify and quantify their concerns with implementing this reform at Phase 1.

196. We also propose to remove the prohibition against incumbent LECs offering competitive response tariffs when the requirements of Phase 1 have been met. A competitive response tariff is a contract tariff that a LEC initiates when it responds to a competitor's offer to an end user, or in response to a request for proposal.[259] By requiring that a competitor be

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[257] GTE Comments at 18-19; USTA Comments at 26-27; U S West Comments at 20-21.

[258] *See* Pacific Bell Comments at 45; *see also* Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 4 FCC Rcd 2873, 3033-34 (1989) (excluding Tariff 12 and Tariff 15 services from price cap regulation).

[259] We note that the D.C. Circuit recently reversed and remanded a Commission Order rejecting Southwestern Bell tariff provisions that would have permitted Southwestern Bell to respond to a customer's request for proposal to provide access services in a competitive bid situation. *Southwestern Bell Telephone Company v. FCC*, No. 95-1592 (D.C. Cir. Nov. 26, 1996).

present, competitive response tariffs by definition provide an additional justification for being made available at this phase. To the extent that parties disagree with our proposed treatment of contract tariffs offered in response to requests for proposals, we invite comments demonstrating why different conclusions would be in the public interest.

d. Deregulating New Services

197. We also seek comment on whether to permit incumbent LECs to offer certain access services outside price cap regulation upon achievement of the Phase 1 trigger. Such treatment might be possible because a baseline access offering exists that ensures continued provision of a core service at reasonable rates. The ability of incumbent LECs to offer some access services outside price caps could create incentives for incumbent LECs to introduce services using the capabilities of new technologies. Modifications to our regulatory regime along these lines for such services could increase customer choice, streamline regulation, and increase consumer welfare by increasing incentives for innovation.

198. As BOCs are permitted to enter the long-distance market, however, their long-distance affiliates may well be purchasing many of these new services, as long-distance carriers with LEC affiliates may well today. We seek comment on whether this may give rise to circumstances in which the LEC could reduce the effects of competition if it offered certain new services outside price cap regulation. If so, when? We also ask whether the section 202 prohibition against discrimination and, with respect to the BOCs, the section 271(c) checklist and the section 272(e)(3) requirement that a BOC charge its long-distance affiliate an amount for access that is no less than the amount charged to any unaffiliated interexchange carriers, provide sufficient protection against possible anticompetitive conduct that we need not make special exceptions to our proposal. We also seek comment on the relationship of this proposal to the requirement to unbundle network elements under the 1996 Act.

199. We also seek comment on whether we could deregulate new services. In the Third Report and Order, below, we eliminate the need for obtaining a waiver before an incumbent LEC introduces a new service, and instead require that it show that the new service is in the public interest. We now seek comment on whether we should eliminate all requirements that an incumbent LEC obtain any regulatory approval before a tariff introducing a new service can take effect. Many new services take advantage of new technical capabilities, and the delay entailed in obtaining regulatory approval may harm consumer welfare. Because the underlying core access service offerings, as well as unbundled network elements, would still be available, there may be little benefit from requiring an incumbent LEC to obtain regulatory approval before introducing a new service. We ask whether, if the new service is far superior to the existing service, the availability of the old service may not provide sufficient safeguards. The availability of the core service also raises the question of whether price regulation of new services is still needed or warranted. If not, these services could be removed from price cap regulation. Alternatively, if such services are not removed

from price cap regulation altogether, we seek comment on whether we should eliminate the new services test. We seek comment on these alternatives. Parties are invited to comment on whether relaxed regulation is more appropriate for some types of new services than it is for other new services.

200. Finally, we seek comment on whether, if we adopt the proposal in the preceding paragraph, we should also remove from price cap regulation some services that have required waivers in the past for their introduction. This would equate the treatment of existing services that were introduced following a waiver request to that for future new services. One example of such a service is 500 access service, which allows IXCs to offer their customers a service by which a call to one number is routed to a different telephone number at different times, or in different sequencing arrangements (a "follow-me" service).[260] This service offers specialized features for which continued regulation may not be necessary if competing carriers can develop substitute services to respond to customer needs. We seek comment on this example, and seek comment on whether other similar services exist for which continued price cap regulation may not be necessary.[261]

C. Phase 2 -- Actual Competition

201. In this subsection, we seek comment on the removal of additional regulatory constraints from incumbent price cap LECs upon the establishment of an actual competitive presence for an exchange access service in a relevant geographic area. A competitive presence short of substantial competition would help to ensure that the opening of the network has happened in fact, not just in theory, and would allow for further reforms under conditions short of the substantial competition necessary for full deregulation and detariffing. At Phase 2, we are seeking comment broadly on: (1) eliminating price cap service categories within baskets; (2) removing the ban on differential pricing for access among different classes of customers; (3) ending mandatory rate structure rules for transport and local switching; and (4) consolidating traffic-sensitive and trunking baskets. We are also seeking comment on whether and how to implement these reforms, or equivalent reforms, if the development of competition comes at significantly different rates for different switched access services in different areas. These reforms would appear appropriate because the competition present at Phase 2, together with the availability of unbundled network elements and the continuing price cap limits on price increases, should restrain incumbent LECs from overcharging their customers. We seek comment as well on how to define competitive presence for these purposes, including whether we should define the term differently for certain of the above reforms than for others. Finally, we seek comment on various alternatives -- including whether we should remove any

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[260] Ameritech Operating Companies et al., Petitions for Waiver of Sections 69.4(b) and 69.106 of the Commission's Rules, Order, 9 FCC Rcd 7873 (Com. Car. Bur. 1994).

[261] *See also* Section VIII.C, *infra.*

of these regulatory constraints at Phase 1; whether we should remove additional regulatory constraints at Phase 2; and whether we should wait until substantial competition has developed, as described above, before eliminating some or all these constraints.

1. Trigger and Relevant Markets

202. We invite comment on three possible factors for determining whether an incumbent LEC has met the trigger for Phase 2: (1) demonstrated presence of competition; (2) full implementation of competitively neutral universal service support mechanisms; and (3) credible and timely enforcement of pro-competitive rules. We also ask whether the proposals for deregulating new services we seek comment on in subsection V.B.2.d, above, would be better suited for Phase 2. We seek comment on whether we should adopt any or all of these factors for the Phase 2 trigger point, and whether there are other competitive factors that we should consider.

203. First, we seek comment on how to determine when competition is sufficient to end mandatory rate structure rules for transport and local switching, remove the ban on differential pricing for access among different classes of customers, eliminate price cap service categories within baskets, and consolidate the traffic-sensitive and trunking baskets. We could measure market share as one factor, among others, in determining whether competition exists in a given market for purposes of removing the regulatory constraints we have identified. As we observed in the *Price Cap Second FNPRM*, we previously have used market share as one factor in measuring the presence of competition.[262] Nevertheless, there are drawbacks to using market share. An analysis of the level of competition for incumbent LEC services based solely on an incumbent LEC's market share at one time may not provide an adequate basis for us to conclude that a competitive presence truly exists. Further, we lack data on the relative market shares of incumbent LECs and their rivals, and thus would need to develop reasonable and nonburdensome ways to gather that information if we were to rely on it.[263] If the Commission considers the relative market shares of the incumbent LECs and their competitors as one factor in assessing the level of competition for incumbent LEC services, what data and information about incumbent LECs and their competitors would be necessary to assess their relative market shares? Also, we would have to determine the appropriate market to be measured and the unit of measurement, such as customer lines, revenues, or access minutes. We seek comment on whether using a market share trigger could affect how the market develops. We seek comment on whether, notwithstanding an absence of competitive entry, the incumbent could be adequately restrained from raising its prices such that it could

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[262] *Price Cap Second FNPRM*, 11 FCC Rcd at 921.

[263] In the interexchange market, the Commission has required AT&T to report quarterly data concerning its share of interstate calling. *See* Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, 11 FCC Rcd 3271, 3357 (1995).

obtain Phase 2 treatment. If we were to adopt any new reporting requirements for purposes of calculating market share, we invite comment on what effect this requirement would have on incumbent LECs considered "small businesses" for purposes of the Regulatory Flexibility Act.

204. In addition to measuring market share as a percentage, we seek comment on the possible use of absolute measures of competitors' presence for services in an area. For instance, we ask parties to discuss whether a competitive presence should be measured in terms of an absolute number of customer lines, residential lines, or access minutes. Are there other factors that could be measured that could support a finding of competitive presence, *e.g.*, a specified number of competitive switches; or a certain number of customers receiving service from unbundled network elements or competitive facilities? What should be the relative importance of a measurement of competition in light of other factors that we propose to incorporate into our analysis and on any other factors that may be proposed? On one hand, a simple measurable test would be easier to administer than most other potential tests; on the other hand, the real significance of any particular competitive presence in the marketplace often only becomes clear after analyzing several different variables that measure competition.

205. We propose to apply any market-presence test we might adopt on a service-by-service basis. For example, we propose to allow an incumbent LEC to establish differential rates for transport when that incumbent LEC has satisfied the Phase 2 trigger for transport, even if there is no demonstrated presence of competitors for local switching. Such an approach would allow the incumbent LEC to respond to competitive alternatives for specific services, which should result in lower prices and more efficient utilization of the network, without permitting incumbent LECs to raise rates unreasonably for less competitive services. Also, this approach would be consistent with our proposal to remove services from price cap regulation when they are subject to substantial competition.[264] Certain Phase 2 proposals, such as elimination of service categories and consolidation of price cap baskets, may not be amenable to implementation on a service-by-service basis. We seek comment on how any such elements of Phase 2 regulatory relief should be implemented.

206. A second possible factor to consider in determining whether the Phase 2 trigger has been met is whether the universal service programs available to incumbent LECs and other eligible telecommunications carriers are competitively neutral.[265] The Universal Service Joint Board recommended that both the collection mechanism and the disbursement

[264] *See* Section II.D, *supra*.

[265] The Joint Board has recommended permitting competitive LECs to be eligible for universal service support only if they meet the criteria specified in Section 214(e)(1) of the 1996 Act. *See Joint Board Recommended Decision* at para. 155.

mechanism for universal service programs be competitively neutral.[266] We ask whether some consumers will not see the benefits of competition if the state universal service programs are not competitively neutral. If in practice only incumbent LECs can receive universal service support, then the disbursement mechanism is not competitively neutral. Customers should be able to choose their provider based on who best serves their needs, not on which provider specifically qualifies for a subsidy payment. We seek comment on this proposed factor.

207. We ask to what extent and how enforcement of pro-competitive rules should be a factor in determining whether Phase 2 has been achieved. Any state or federal rules or rights must be enforced vigorously and swiftly so that consumers enjoy the benefits of the promised competition. States and the FCC have a duty to create forums for fast, fair and efficient dispute resolution. We seek comment on whether enforcement should be used as a Phase 2 condition, and if so, on what the specific criteria should be for determining whether enforcement is adequate.

208. We also seek comment here on whether additional or different conditions should apply before implementing Phase 2 reforms. For instance, we seek comment on whether our definition of actual competitive presence should differ for implementing various of the reforms discussed here. Should we require greater competitive pressures on incumbent LEC access charges before we implement certain of the reforms discussed below? If so, which ones, and why? We also seek comment on the extent to which an actual competitive presence, from entrants purchasing unbundled elements, using their own constructed facilities, or a combination of the two as a substitute for current access service, would provide incumbent LECs incentives to reduce access charges. If it develops that carriers are competing for end-user customers primarily by providing bundles of local and long distance service, to what extent would incumbent LECs decide not to lower access charges charged to IXCs, but instead to raise them as high as possible as long as possible? If this occurs for certain groups of customers, or in certain areas, should this affect how we implement reforms at Phase 2, and, if so, how? To what extent is this competitive dynamic affected by the absence of a legal requirement under the 1996 Act that a requesting carrier provide local exchange service to an end user in order to purchase unbundled network elements and use them as a substitute for access service? To what extent would the continued constraints of price cap regulation for certain access services, perhaps as modified according to certain of the methods discussed in the prescriptive approach to access reform, provide sufficient protection during the transition to substantial competition?

209. We solicit comment on the procedures that an incumbent LEC should follow to demonstrate that it has met the Phase 2 triggers for one or more services. Petitioners should discuss whether an incumbent LEC should file a petition for waiver, a petition for declaratory ruling, or some other filing, and how the incumbent LEC should satisfy its burden of proof.

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[266] *Joint Board Recommended Decision* at para. 23.

210. We also seek comment on the relevant geographic area that should be considered in determining whether an incumbent LEC has met the Phase 2 competitive trigger. As discussed in Section II.D.1 above, there are several possible ways of specifying geographic areas. We tentatively conclude that any geographic area used in considering the presence of substantial competition would be appropriate for purposes of Phase 2. Moreover, by not requiring parties to maintain data on multiple geographic areas, such an approach would keep administrative burdens on all parties to a minimum. We seek comment on this tentative conclusion.

2. Reforms

a. Service Categories Within Baskets

211. The price cap service categories were developed both to protect ratepayers from precipitous changes in the prices for incumbent LEC services, and to prevent incumbent LECs from disadvantaging one class of ratepayers to the benefit of another class.[267] We tentatively conclude that, given competition in Phase 2, the current service categories in the trunking and traffic-sensitive baskets would no longer be necessary. We invite comment on how we should eliminate service categories, because doing so on a service-by-service basis appears infeasible. While the upper service band indices (SBIs) prevent incumbent LECs from offsetting price reductions in one service category with increases for less competitive services, the development of a competitive presence will provide IXCs with the alternatives of obtaining service from competitive LECs or using unbundled network elements instead. We seek comment on eliminating the current service categories at Phase 2. Parties should address whether there will be a need for any service categories at that point, to describe those categories, and to explain why it would be in the public interest to retain them.

b. Differential Pricing for Access to Different Classes of End-Users

212. While we generally have not considered differential pricing for access services to different classes of customers in prior proceedings (except for the Subscriber Line Charge), we seek comment on whether we should permit such flexibility at Phase 2. As used in this Notice, we define differential pricing as permitting incumbent LECs to charge different rates for access to different classes of customers.[268] There are at least three classes for which differential pricing may be appropriate: residential, single-line business, and multi-line

[267] *LEC Price Cap Order*, 5 FCC Rcd at 6811-12.

[268] *NYNEX November 5 Proposal* at 11.

business.[269] We invite parties to suggest additional classes, and to analyze why rates for access to such classes should be afforded differential treatment. We seek comment on whether, for incumbent LECs that use differential pricing for their access rates, we should adopt some safeguards to protect the classes of customers not subject to competition, *e.g.*, residential and single-line business, and if so, what those safeguards should be.

213. Differential pricing for access could pose the same substantial risks to competition that accompany contract carriage and RFPs,[270] but, because differential pricing would enable an incumbent LEC to adjust all prices for access to a class of customers within a zone at the same time, the risks would be on a greater scale. We seek comment on whether we should permit incumbent LECs to offer differential pricing for access once the requirements of Phase 2 have been met.

c. Rate Structure Rules for Transport and Local Switching

214. We seek comment on eliminating the rate structure rules for the transport and local switching rate elements at Phase 2. We would also eliminate the mandatory rate structure modifications for transport and local switching that we propose in Section III, above. At Phase 2, if an incumbent LEC attempted to establish an inefficient rate structure, an IXC would be able to avoid paying above-cost rates by using cost-based unbundled network elements to originate and terminate toll traffic, or by acquiring access from a competitive provider. We will be able to rely on the presence of competitors to oblige the incumbent LECs to establish rate structures that reflect the manner in which costs are incurred. We do not propose to introduce this reform at Phase 1, even though unbundled network elements can act as an effective substitute for switched access at that point. We tentatively conclude that we should allow the Phase 1 reforms to take their effect prior to eliminating our mandatory rate structure rules, because it is not clear that the mere existence of efficient rate structure rules for unbundled network elements will cause incumbent LECs to adopt efficient access rate structures. For example, incumbent LECs may have an incentive to set per-minute access charges to raise the cost for interexchange resellers, who may have difficulty vertically integrating. This pricing would raise the marginal costs of those IXCs, distorting competition and raising prices and the profits of a LEC or its interexchange affiliate. We seek comment on this reform, and on when our mandatory rate structure rules should no longer apply. We

[269] We have previously distinguished among these classes in determining how to assess the SLC. *See, e.g.*, 47 C.F.R. §§ 69.104, 69.105, 69.203; MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, Decision and Order, CC Dockets No. 78-72 and 80-286 (rel. Dec. 28, 1984), 50 Fed. Reg. 939 (Jan. 8, 1985).

[270] *See* Section V.B.2.c, *supra*.

also seek comment on whether we should keep our rate structure rules for terminating access even after we have removed them for originating access.[271]

215. In conjunction with elimination of transport and switching rate structure rules, we also ask parties to comment on whether carriers satisfying Phase 2 requirements should be permitted to apportion access charges between carrier and end user according to marketplace pressures. In this regard, incumbent LECs would be treated in the same manner as competitive LECs, with neither a requirement nor a prohibition against adopting the most commercially appropriate rate structure.[272] Commenters should discuss whether we should permit LECs to collect charges from end users for originating access, terminating access, or both, and whether such charges should be imposed on the party placing a call or the party receiving the call.[273] Commenters should also address whether providing this flexibility might violate section 254(g), which prohibits interexchange rates in rural or high cost areas from exceeding rates in urban areas.[274] Alternatively, we seek comment on any steps we should take to ensure that an IXC can recover access charges from its customers in an efficient manner.

d. Consolidation of the Traffic-Sensitive and Trunking Baskets

216. When we created the price cap baskets for incumbent LECs, each with separate price cap indices and bands, we balanced two competing concerns. First, we limited the number of baskets to ensure that the company-wide productivity offset would be appropriate for each basket. Second, we sought to limit the incumbent LECs' ability to subsidize price decreases for competitive services with price increases for services in a less competitive basket.[275] We expect that competition in trunking and switching will develop at approximately the same rate. Thus, the need to separate the traffic-sensitive and trunking baskets is reduced. We do not seek comment on consolidating the common line basket, because the common line possesses different bottleneck characteristics than do local switching and transport. These differences are likely to cause competition for common line services to develop differently than and probably generally lag somewhat behind competitive developments in the traffic-sensitive and trunking baskets.[276] We do not seek comment on

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[271] *See* Section VIII.A, *infra.*

[272] We discuss issues relating to the common line in Section III.A, *supra.*

[273] End User Billing of Originating Access, BellSouth, Oct. 30, 1996.

[274] 47 U.S.C. § 254(g).

[275] *LEC Price Cap Order*, 5 FCC Rcd at 6811-12.

[276] *See* Section VIII.A, *infra.*

consolidating the interexchange basket because services within the interexchange basket are more competitive, and so are likely to be subject to substantial competition more quickly than traffic-sensitive or trunking services.[277] At this point, we invite comment on consolidating the traffic-sensitive and trunking baskets, enabling incumbent LECs to price their services more efficiently in response to the competitive market. Consolidating the traffic-sensitive and trunking baskets also reduces the administrative burdens placed on incumbent LECs.

217. We have considered modifying price cap baskets in the past, but declined to do so in the absence of information about the state of competition in the local telephone markets.[278] We suggest two possible points at which to remove this constraint: Phase 2 or in conjunction with the phase-out of the TIC, discussed below.[279] Our Phase 2 triggers should assess competition adequately for the purpose of determining whether incumbent LECs should be able to consolidate the traffic-sensitive and trunking baskets. Until the incumbent LEC reaches Phase 2 for each basket, it continues to face less competition for the services in one of the baskets relative to the services in the other. During this time, an incumbent LEC that can consolidate these baskets may still have an incentive and the ability to engage in anticompetitive behavior. We believe that in order to reduce this incentive, incumbent LECs would have to reach Phase 2 for each of the services within these baskets. Nevertheless, it may be better to permit consolidation of the traffic-sensitive and trunking baskets as part of the incumbent LECs' phasing out of the TIC. Removing this constraint at the time of the TIC phase-out would provide a method for incumbent LECs to reassign costs from the TIC. We seek comment on consolidating the traffic-sensitive and trunking baskets, particularly on when the consolidation should take place. We ask parties that favor consolidating the traffic-sensitive and trunking baskets as part of the incumbent LECs' phasing out of the TIC address what would ensure that incumbent LECs would not engage in anticompetitive behavior with respect to the services within these baskets.

VI. PRESCRIPTIVE APPROACH TO ACCESS REFORM

A. Introduction

218. In Section V above, we have set forth a framework under which we would reduce or eliminate, in phases tied to the potential for and growth of competition, access charge requirements that constrain rate structures and price levels. Some parties, such as

[277] Petition to Regulate Bell Atlantic as a Nondominant Provider of Interstate InterLATA Corridor Service (filed July 7, 1995).

[278] *LEC Price Cap Performance Review Order*, 10 FCC Rcd at 9142.

[279] *See* Section III.E, *supra*.

MCI, may contend that a market-based approach is inadequate to the task of reforming access.[280] Such parties might argue that, at best, competition will emerge unevenly among geographic areas, services, and customer classes, and argue that a second option for access reform, a prescriptive approach, should be followed. Although a prescriptive approach would move access rates to forward-looking economic costs in a more predictable and uniform manner than a market-based approach, such an approach would also require that the Commission play a greater role in the telecommunications marketplace. In Section IV.A above, we invite comment generally on whether a market-based approach, prescriptive approach, or some combination of the two approaches provides the best path for access reform.

219. In this Section, we seek comment on the specific requirements we should apply to incumbent LECs if we adopt an alternative, more prescriptive approach to access reform. First, we invite comment on the goal of a prescriptive approach. Next, we invite comment on a number of proposals, many of which have been suggested by industry participants, for specific requirements that could be incorporated into the prescriptive approach. Many proposals discussed below are designed to reduce access rates generally, because reducing access rates should in most, if not all, cases result in rates that are closer to cost. One of our proposals is to prescribe TSLRIC-based access rates, which would force rates to cost more effectively than our other proposals, but would also be more administratively burdensome. Finally, we address establishing phases for prescriptive access reform, to avoid the market disruptions that might occur if we required incumbent LECs to move interstate access rates to cost on a "flash-cut" basis.

B. Goal of Prescriptive Access Reform

220. In both the prescriptive approach to access reform discussed in this Section and the market-based approach discussed in Section V, we seek to develop competition for interstate access services, which will ultimately result in the deregulation of these services. As we have emphasized elsewhere in this Notice and in other proceedings, the 1996 Act commands us to foster efficient competition in all telecommunications markets and to remove regulation when marketplace forces will drive competing providers to lower their costs and prices and offer services that are responsive to the demands of consumers. An intermediate goal of the market-based approach is to permit market forces to drive interstate access rates to economically efficient levels. We propose adopting a similar intermediate goal for prescriptive access reform; *i.e.*, we propose to adopt rules that would drive access rates to economically efficient levels.[281] MCI and AT&T have argued that interstate access rates, as well as prices for unbundled network elements offered pursuant to the 1996 Act, should be

[280] *See, e.g.*, "MCI Urges FCC to Fold Price cap Proceeding Into Access Charge Reform," Communications Daily, Vol. 16, No. 239, Dec. 11, 1996, at 2.

[281] NARUC suggested seeking comment on the goals of access reform. *See NARUC October 23 Letter* at 3.

based on the forward-looking economic costs of those services or elements.[282] Those IXCs have also submitted computer models designed to calculate forward-looking economic cost.[283] Specifically, in the case of access services, the model calculates "Total Service Long Run Incremental Cost" (TSLRIC) of the access service, and in the case of unbundled network elements, the model calculates the TSLRIC of network elements, also known as Total Element Long Run Incremental Cost (TELRIC).

221. An incumbent LEC's TSLRIC for a given service or facility, such as exchange access service, should include all incremental costs directly attributable, or dedicated, to the delivery of the service or facility in question. Carriers also should be allowed to recover a reasonable allocation of their forward-looking common costs, defined as those costs that are incurred in connection with the production of multiple products or services that remain unchanged as the relative proportion of those products or services varies. We note that when calculating the forward-looking economic cost of exchange access services, because these services share common network facilities with other incumbent LEC-provided services, such as local exchange service and intraLATA toll, fewer costs will be directly attributable or dedicated totally to exchange access services. Consequently, the incumbent LEC may need to recover significant common costs in addition to the TSLRIC of exchange access. These common costs should be recovered in a manner that is economically efficient and consistent with the pro-competitive goals of the 1996 Act. By contrast, the TELRIC of a specific facility, such the loop or the switch, would directly attribute to that facility all costs caused by that facility, regardless of the services provided by that facility. Consequently, the forward-looking common costs that the incumbent LEC must recover in addition to the TELRIC of that facility in order to recover forward-looking economic costs are lower than the forward-looking common costs that need to be recovered for a service. Additionally, the forward-looking costs of unbundled network elements should not include the costs of billing and marketing to end users, because unbundled network elements are intermediate products offered to competing carriers.

222. Under both TSLRIC and TELRIC-based pricing methodologies, prices should be based on forward-looking economic costs, including a reasonable allocation of forward-looking joint and common costs, and allow incumbent LECs to earn a fair, risk-adjusted rate of return on their investments. Such pricing should encourage efficient and effective entry

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[282] *See, e.g., AT&T November 22 Letter* at 4.

[283] *See* The Cost of Basic Network Elements: Theory, Modeling and Policy Implications (Hatfield Associates, Inc. March 1996), submitted by MCI on March 29, 1996 (*Hatfield Model*). MCI basis its estimate on 1993 data. *Hatfield Model* at 34-35. We note that this model has since been revised. *See* Hatfield Model, Version 2.2, Release 1, (Hatfield Associates, Inc., March 1996), submitted by AT&T and MCI on May 16, 1996 (*Hatfield 2.2*); *see also* AT&T Reply in CC Docket No. 96-98 at Appendix D (Update of the Hatfield Model Version 2.2, Release 1); *AT&T November 22 Letter* at Appendix A (further update of the Hatfield Model, Version 2.2, Release 2).

into the local telecommunications marketplace. Commission staff will soon be releasing for comment an analysis of the use of computer models in estimating forward-looking economic costs. In the event we determine that a market-based approach will not result in the development of efficient competition, we tentatively conclude that our goal for prescriptive access reform should focus on interstate access rates based on some form of a TSLRIC pricing method. We seek comment on this tentative conclusion. Below, we seek comment on several proposals for rules that would drive interstate access rates to TSLRIC levels.

C. Specific Regulatory Requirements

1. Readjustment of Rates to Economic Cost Levels

223. In the *LEC Price Cap Performance Review*, we required incumbent price cap LECs to adjust their price cap indices (PCIs) downward to reflect our decision to revise, in light of our past experience with price cap regulation, one of the economic studies on which we based the X-Factor in the *LEC Price Cap Order*.[284] In this Section, we seek comment on whether we should require a similar reinitialization in this proceeding. Specifically, we seek comment on the feasibility of readjusting the PCIs applicable to an incumbent LEC's baskets on the basis of a TSLRIC-based study. This would be one means of implementing the proposals of AT&T and MCI that access rates should be set at forward-looking economic costs.[285] Under this approach, we would determine the forward-looking incremental costs of providing all the access services in a price cap basket, and then add a suitable allocation of forward-looking common costs. Finally, we would require incumbent LECs to reduce their PCIs by an amount equivalent to the difference between their current PCIs and the TSLRIC revenues of providing the services in each basket. One benefit of requiring such a reinitialization is that it would enable us to avoid the administrative burdens associated with determining the proper allocation of common costs to each service within a basket. On the other hand, the reinitialization of PCIs we consider in this Section would simply lower rate levels. It would not guarantee that the incumbent LECs' rate structures would be reasonable. We seek comment on whether rate structure concerns should outweigh our concerns regarding the administrative burdens of allocating common costs. In Section VI.C.4 below, we seek comment on prescribing rate levels and rate structures based on TSLRIC studies, which would help ensure that incumbent LECs' rate structures are reasonable, but would also require us to determine how to allocate common costs.

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[284] *LEC Price Cap Performance Review Order*, 10 FCC Rcd at 9069-73. For a discussion of the economic study at issue in the *LEC Price Cap Performance Review*, *see* Appendix C of the *LEC Price Cap Order*, 5 FCC Rcd at 6885-6928.

[285] *AT&T November 22 Letter* at 4.

224. In order to reinitialize PCIs to levels that are consistent with the TSLRIC of incumbent LECs' access services, the Commission could evaluate incumbent LECs' TSLRIC studies for each price cap basket. This approach, however, could impose significant and potentially costly burdens on the FCC, incumbent LECs, and interested parties. Alternatively, state commissions might be better suited to evaluate TSLRIC-based studies because state commissions generally have more experience with cost studies.[286] Under this approach, which we could implement under section 410(a) of the Act,[287] we would rely on the state commissions' results to determine the difference between current interstate access rates and forward-looking economic cost-based access rates, and reinitialize interstate PCIs based on this difference. This approach ensures coordinated treatment between jurisdictions. We seek comment on this alternative and invite parties to comment on what, if any, federal guidelines should be established for the conduct of these state studies. Commenters should also suggest alternative proposals for reinitializing PCIs at forward-looking, economic cost, in the event we determine that a market-based approach will not result in economically efficient rates.

225. We seek comment on whether TSLRIC calculations for the services in some price cap baskets could be based in part on or derived from the TELRIC of certain unbundled network elements. TSLRIC and TELRIC are different versions of the same pricing methodology. To the extent that states reviewing arbitration agreements governing the prices of unbundled network elements rely on TELRIC studies, those studies might also provide data useful for determining TSLRIC rates for access prices. We seek comment generally on the feasibility of using prices derived from individual network element costs to establish prices for interstate access service. In particular, are there access services that employ dedicated facilities that are equivalent to an unbundled network element, and in those cases, would there be any difference between the TSLRIC of the access service and the TELRIC of the unbundled network element? For instance, it is not clear that the TSLRIC price of dedicated transport service, as opposed to tandem-switched transport service, should significantly differ from the TELRIC of a dedicated transport element. We also seek comment on what costs, if any, should be included in the price of interstate access that are not included in the price of unbundled elements.[288] For example, we ask commenters to address the nature of marketing and other customer operations costs that are involved with the provision of access services, and ask that they identify any costs that are incurred in the sale of access services that are not incurred in the sale of unbundled elements.

[286] In Section VII.B, *infra*, we solicit comment on adopting this approach to determine the prudency of residual costs.

[287] 47 U.S.C. § 410(a).

[288] *See NARUC October 23 Letter* at 3.

226. In addition, we solicit comment on whether it is possible to reduce the administrative burdens associated with this approach by deriving estimates for TSLRIC-based prices in some study areas from TSLRIC or TELRIC studies conducted previously in other study areas. Is there a generic cost model that could be used to determine TSLRIC-based interstate access prices?[289]

227. Some parties that advocate readjusting access rates to the TSLRIC level maintain that TSLRIC rates would, in most cases, result in access rate reductions. In Section VII.A below, we seek comment on whether this is the case, the reasons therefore, and the magnitude of any differential. TSLRIC-based rates by definition would not be based on the level of embedded costs, regardless of whether embedded costs exceed TSLRIC-based rates or TSLRIC-based rates exceed embedded costs. We note that the presence of competitive LECs might increase incumbents' cost of capital, and might warrant increasing depreciation rates.[290] These effects might decrease to some extent any difference between TSLRIC-based rates and current rates. In Section VII.B, below, we seek comment on whether and to what extent incumbent LECs should be permitted an opportunity to recover any difference between TSLRIC-based rates and current rates.

2. Reinitialization of Rates on Some Other Basis

228. In the event we determine that a market-based approach to interstate access charge reform will not move rates closer to their economic cost, and reinitialization of PCIs based on TSLRIC studies or TELRIC cost models is not feasible, we could reinitialize PCIs on some other basis. For example, we could reduce PCIs to a level that would result in rates targeted to yield a rate of return of no more than 11.25 percent. A second basis for reinitialization could be to prescribe a new rate of return and then reinitialize access rates based on that rate of return as urged by MCI, AT&T, and GSA in the LEC Price Cap Performance Review proceeding.[291] Developing a new starting point for incumbent LEC PCIs under either of these two approaches might be reasonable for several reasons. First, to the extent that current price cap rates include a cost of capital greater than that necessary to enable carriers to attract investors, these rates may not represent the most reasonable balance between ratepayer and stockholder interests. Second, although we found in the *LEC Price Cap Performance Review Order* that there was not sufficient reason for reducing access rates

[289] *See AT&T November 22 Letter* at Appendix A.

[290] We discuss the relation between depreciation and residual costs in Section VII.B, *supra*. Issues related to our depreciation rate prescriptions, or our methods for prescribing depreciation rates, are beyond the scope of this proceeding.

[291] *LEC Price Cap Performance Review Order*, 10 FCC Rcd at 9064-65.